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Proposal for Amendments of the United Nations Model Double Taxation Convention between Developed and Developing Countries: Further Issues Relating to Permanent Establishment*

Summary

This paper has been provided by the subcommittee on Definition of Permanent Establishment for consideration at the Fourth Annual Session of the Committee of Experts on International Cooperation in Tax Matters (the Committee). It represents a second stage of the mandate given to the subcommittee. The first stage of that mandate represented by paper E/C. 18/2007/3/Rev.1 (considered by the Third Annual session of the Committee and approved with some amendments) proposed a new Commentary for the existing Article 5. This second stage of the Mandate requested the subcommittee to consider the desirability or otherwise of amending Article 5 (including its attendant Commentary) to address issues arising from:

- the treatment of Article 14, including possible deletion (Chapter II) at paragraphs 3 – 105;
- the taxation of fees for technical services (Chapter III) at paragraphs 106 – 127; and
- the treatment of services generally (Chapter IV) at paragraphs 128 – 131.

Contents

I. Introduction

1. At the Third Annual Session of the Committee of Experts on International Cooperation in Tax Matters in 2007, the subcommittee on the Definition of Permanent Establishment was invited to continue its work with a mandate for the Fourth Annual Session (2008) as follows (Report of the Committee's Third Annual Session, E/C.18/2007/19, paragraph 54):

> It was agreed that the paper on an updated commentary to the existing article 5 had been finalized, taking into account the need to make a small number of minor changes to the draft, as noted in the discussions. The subcommittee was mandated to continue its work on the updating of document E/C.18/2007/CRP.4 regarding a possible new article 5 and Commentary on that article in time for consideration at the Committee's fourth session, taking into account the issues raised in the discussions.

2. This paper updates document E/C.18/2007/CRP.4. It involves consideration of the following basic issues, which include the subsidiary issues mentioned in the mandate above (In this paper, references to Articles in the Model and paragraphs in the Commentaries on those Articles are references to Articles in the UN Model and the Commentaries thereon, unless otherwise indicated.):

- The treatment of Article 14, including possible deletion (Chapter 2) at paragraphs 3 - 105
- The taxation of fees for technical services (Chapter 3) at paragraphs 106 - 127
- The treatment of services generally (Chapter 4) at paragraphs 128 - 131

In pursuing its mandate, the subcommittee considered whether to present a draft revised Commentary to accompany the proposed changes to Article 5 addressed by this paper - for consideration by delegates at the Fourth Annual Session of the Committee. However, that would be a substantial document for consideration in itself, and the subcommittee ultimately considered that it would be more productive to present the conclusions of the subcommittee in terms of a proposed revision of the Article itself, with the reasoning for its proposals, and to focus the debate on these points, so as to, as far as possible, agree the form of that article and the key underlying points behind those changes at the Fourth Annual Session. That agreement would then form the basis for a draft Commentary which would be an elaboration on the revision of the text agreed at the Third Annual Session in 2007 (subject to some amendments that have since been made) and provided for reference in paper E/C.18/2007/CRP.3/Rev.1. That text would then be modified to address the deletion of Article 14, if agreed, and any other agreed changes to the text of Article 5, drawing upon this paper and the discussion of it at the Fourth Annual Session.

II. The Possible Deletion of Article 14 and Incorporation in Articles 5 and 7

A General

3. The subcommittee's starting point and aim in addressing the possible deletion of Article 14 was, in accordance with its mandate, to maintain the source taxation principles as expressed in the current UN Model, and to keep the appropriate taxation balance between source and residence States. While one member of the subcommittee noted a preference for retaining Article 14 in the circumstances of his country, ultimately the subcommittee considered that the benefits of deleting Article 14 and relying in

such cases on the established "permanent establishment" terminology would assist administrators, potential investors and advisors, while not disturbing the balance of source and residence country taxing rights.

4. Annex 1 to this paper therefore provides the current relevant Articles of the UN Model (Articles 3, 5 and 14). Annex 2 contains the subcommittee's proposed texts of Articles 3, 5 and 14 (deleted), and the texts of the other articles that need amendment as a consequence of the changes in Articles 5 and 14. Annex 3 contains text for use by countries wanting to preserve the existing structure, including Article 14, Annex 4 indicates proposed consequential changes to Commentaries on Articles other than Article 5 of the UN Model, as the subcommittee found it useful to contextualise the proposed changes. Annex 5 gives a brief account of the "fixed base" concept relevant to this discussion, in particular to the deletion or otherwise of Article 14.

B Main arguments for deletion of Article 14 – a consideration[1]

5. The main reasons in *favour* of deleting Article 14 were, in the subcommittee's view, the following:

(i) Coverage of activities other than professional services

6. The subcommittee noted the *uncertain coverage* of Article 14. In particular, the issue of to which activities it applies, including whether it covers activities other than the furnishing of professional services. On one view, Article 14 deals with types of income not addressed by Article 7, so that removal would jeopardise the taxation of professional service income, for example. The subcommittee considered this view and felt that while the application of Article 14 to professional services was clear, its application to "other activities of an independent character" was ambiguous. It is not clear how extensive this formulation is intended to be, nor how much overlap is created with activities falling within Article 7 (Business profits). Literally, it goes beyond professional services because it includes "other activities of an independent character (i.e. not merely of a "similar" character, which is a formulation that appears in some earlier treaties), but there is an issue of how far it goes beyond professional services. For example, do the activities of sub-contractors in the construction industry, which would otherwise come under Article 7, fall within this formulation?

7. In practice, many countries apply Article 14 only to professional services, thereby effectively ignoring the reference to "other activities of an independent character". This is not surprising since, if read literally, the phrase could potentially apply to any activity falling under Article 7, thereby making that Article redundant. A narrow approach is favoured by paragraph 10 of the Commentary on Article 14, which states (quoting paragraph 1 of the OECD Commentary) that the Article excludes "industrial and commercial activities", and paragraph 9 of the Commentary on Article 5 explicitly mentions "management and consultancy services" as services "it is believed … should be covered because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money." The apparent inconsistency between the literal

13.

24. The second approach, clearly, would therefore produce a result that would be at odds with that under Article 7, particularly when taking into account the implications of Article 5(5) (the "agency permanent establishment" rule) in the legal context of a partnership.

25. To properly judge as between these two approaches one has to take into account the administrative difficulties that would result from the first approach, which would require each of the partners of a partnership that has offices in many countries to comply with the tax requirements of all these countries (e.g. possibly having to file a great number of tax returns). Under this approach, taxpayers and tax authorities would have to distinguish between the attribution of income to fixed bases and the distribution of the income to the partners in different countries. However, even if the first approach produces the correct result and is preferred; eliminating Article 14 would ensure that the second approach was no longer capable of being argued.

C Main arguments against deletion of Article 14 – a consideration

26. The main arguments in favour of retaining Article 14 from the UN Model, and the subcommittee's response to them, are as f8ns). 5di5.603 T6(le "F(inco)-7"from)"1.15D.0007 Tabavour (ib51.4 two approaches 8( )]19

of a definition of the term “business” which expressly provides that this term includes professional services or other activities of an independent character.

The Committee considers that the reasoning of this OECD text holds equally true for the United Nations Model, although it accepts that for administrative or other reasons some countries may wish, in their bilateral tax treaties, to retain Article 14, whether as a shorter or longer term measure. For this reason, and to assist in the interpretation of existing treaties containing Article 14, the Article 14 text and Commentary, as well as a list of changes to preserve the position under the 2001 version of the United Nations Model are included as Annex [*] to this version of the United Nations Model, as a reference for use in such situations.

Note that paragraph 68 below elaborates on the last point mentioned in the sugges

test of Article 14 is now fully covered by paragraph 6 of the OECD Commentary to Article 5 (see, e.g., “recurrent activities”), which seems to go even further (in relation to “short duration” permanent

the view that any such cases would be so rare (if they occurred at all) as to not have a practical impact on

Article 14 represents a loss of source country taxing rights, and imposes extra burdens upon the administrations of developing countries.

49. Article 7 allows the source State to tax *profits* attributable to a permanent establishment. Article 14,

54. Differing views have been expressed about whether paragraph 3 of Article 24 addresses discriminatory treatment of fixed bases (not specifically referred to) as well as permanent establishments (specifically referred to) – a matter considered in more detail in the following subsection. However, the subcommittee noted that if Article 24 *did* apply to fixed bases at present, taxation on the fixed base could not be less favourably levied than for domestic enterprises carrying on the same sort of service provision. This would in practice render taxation on gross receipts even less likely.

55. The subcommittee considered that in any case there was no policy justification for taxing professional services under Article 14 on a different basis from commercial services under Article 7, and noted that, in practice, it appears most countries recognise this and only tax the net amount under Article 14, consistent with this approach. The subcommittee ultimately considered that the proposed replacement of Article 14 would, in practice, not lead to any significant reduction of source country taxing rights, and that any conceivable effects were heavily outweighed by the benefits of a consistent approach between providers of professional services and other service providers – benefits that would extend to administrations as well as taxpayers and their advisers.

(v) Will the non-discrimination provision of Article 24(3) apply to cases formerly covered by Article 14 because they would now be dealt with by Article 7

56. Another question (adverted to in the previous subsection) is whether the migration of the coverage of independent services from Article 14 (with the fixed base test) to Articles 5 and 7 (with the permanent establishment test) means that the non-discrimination obligation in Article 24(3) would apply where it did not previously, thus affecting the balance of taxing rights between source and residence States.

57. Article 24(3) provides as follows:

> The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

58. The non-discrimination test of Article 24(3) will, for example, affect a State's ability to limit deductibility of costs. This rule disallows a system where e.g. the permanent establishment is subject to more burdensome cost deduction rules than enterprises of the host State. Also, where, e.g., the permanent establishment would be subject to taxation in the host State at a lower tax rate on gross income (no costs deductible), whereas enterprises of that host State would be taxable at the normal domestic tax rate on net income (costs deductible), Article 24(3) could (depending on the parameters chosen for such a taxation rule) be an impediment to States imposing that rule for permanent establishments. The subcommittee notes, however, that it is ultimately the *effect* of the rules that counts. Different rules *as such* applied to permanent establishments and to domestic enterprises are not forbidden.

59. While Article 24(3) strictly only refers to permanent establishments, some commentators consider that the provision implicitly applies in Article 14 cases also. The subcommittee concluded that, whichever view was correct, the non-discrimination provision is an important part of the object and purpose of tax treaties of encouraging investment and that the application of the provision is best viewed as an issue of consistency of application in similar circumstances rather than an issue of the balance of

source and residence State taxation rights. The subcommittee does not consider it is an issue likely to arise often in practice, in any case.

(vi) Should there be a provision, even if Article 14 is deleted, reflecting in Article 5 the former Article 14(1)(c)?

60. There used to be a provision, Article 14(1)(c), that (as noted by paragraph 7 of the current Commentary):

> ... provided a further criterion for source country tax when neither of the two conditions specified in subparagraphs (a) and (b) is met. It was provided that if the remuneration for the services performed in the source country exceeds a certain amount (to be determined in bilateral negotiations), the source country may tax, but only if the remuneration is received from a resident of the source country or from a permanent establishment or fixed base of a resident of any other country which is situated in that country.

The view has been advanced that a small number of countries still use that provision in their modern treaty practice, and they would lose this source taxation right if Article 14 was deleted.

61. The subcommittee notes that Article 14(1)(c) was deleted, as indicated by paragraph 8 of the UN Commentary on that Article, because monetary thresholds tended to become meaningless over time and would potentially only limit the import of services, and because it was little used. The subcommittee considers that countries wishing to preserve such a rule in relation to the furnishing of services could still

64. The subcommittee believes that the UN Model should do the same. It believes that this can be done without raising the threshold for taxation in source count

favour of removing Article 14, which solves the problem, the subcommittee has taken the question no further.

(v) Rewording of Article 5(2)

70. It has occasionally been suggested that the current text of Article 5(2) ("The term 'permanent establishment' includes especially…") means that the paragraph deems each of the items to *automatically* be a permanent establishment. The subcommittee rejects this view.

71. Paragraph 4 of the UN Model Commentary to Article 5 says:

74. The subcommittee believes that Article 5(3)(a) is not intended to be a deeming provision. This follows from the history of that paragraph: construction activities etc. originate from Article 5(2) of the

81. The subcommittee considers, however, that, in the proper maintenance of the source State's taxing rights, that step is not necessary. Indeed, even if – in an unlikely situation – the supervisory enterprise could be considered not to have at its disposal a place of business at the site of the construction, or elsewhere in the country where these activities are performed, the current Article 5(3)(b) would trigger, subject to the remarks below, this permanent establishment.

82. Therefore, the subcommittee proposes the **following text as the new Article 5(3),** reflecting current Article 5(3)(a):

> The term "permanent establishment" also includes a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months.

83. In the proposed re-wording, the term "includes" is used because the current difference in terminology between the terms "includes especially" in paragraph (2) and "also encompasses" in paragraph (3) is, in the subcommittee's view, not justified by any intended difference in meaning, and could confuse those who would expect different phrases used in the same Article to have some intended differentiation in meaning. The subcommittee therefore suggests that the same terminology should be used in the two paragraphs – ("includes in paragraph (2) and "also includes" in paragraph (3)).

84. For the reasons expressed in the next part of the paper, the subcommittee proposes, however, including the current Article 5(3)(b) in a separate, reworded Article 5(4)(a).

(vii) Rewording and renumbering Article 5(3)(b) as Article 5(4)(a)

85. The furnishing of services often takes place without the physical place of business of Article 5(1), which is Article 5(3)(b)'s reason for existence. The provision should be understood as providing for a "deemed" permanent establishment: if the activities of this provision are met, a permanent establishment exists, even though the terms of Article 5(1) may not be met. This is a different situation to that of a construction permanent establishment, where the terms of Article 5(1) are relevant, subject to a special "time test" replacing the normal paragraph 1 time tests.

86. The subcommittee therefore proposes separating the construction permanent establishment paragraph from the services permanent establishment paragraph to reflect these differences. The proposed text, without altering the current substance of Article 5(3)(b), reads:

4. A permanent establishment shall be deemed to exist where:

(a) an enterprise furnishes services through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating

(h) The term “business” includes the performance of professional services and of other activities of an independent character.

98. These changes *ensure* that the full range of activities that currently come within Article 14, including the rendering of professional services, would now come within Articles 5 and 7.

99. Guidance in achieving this is provided by the OECD Model, which brought Article 14 situations under the scope of Article 5 and Article 7 in its year 2000 revision - see paragraph 4 and paragraph 10.2 of the OECD Commentaries to Article 3 on this point. The OECD changes to the text of Article 3 are the same as are now proposed for the UN Model.

100. Paragraph 4 of the OECD Commentary on Article 3 (dealing with the term “enterprise”) reads as follows:

> The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term “enterprise” has therefore been attempted in this Article. However, it is provided that the term “enterprise” applies to the

> The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary may wish to omit the definition of the term "enterprise" from their bilateral conventions.

The second sentence of current paragraph 5 of the Commentary on Article 3 "It does not define …laws of the Contracting States" may then be deleted.

102. Similarly, the subcommittee suggests a new paragraph after the current paragraph 11 of the Commentary to Article 3 (renumbering the subsequent paragraphs) to explain the new Article 3(1)(g). This proposed paragraph is derived from paragraph 10.2 of the OECD Commentary noted above:

> *(b) The term "business"*
>
> The Convention does not contain an exhaustive definition of the term 'business', which, under paragraph 2, should generally have th

(xii) Renumbering of Articles 15 and following?

105. The subcommittee does not propose the renumbering of Articles 15 and following Articles upon the proposed deletion of Article 14. This avoids further consequential changes to the Articles and Commentaries, although States may prefer to do so in their bilateral treaties.

III. Fees for Technical Services

A The UN and OECD Model Backgrounds

106. Fees for Technical Services would typically fall within the scope of Article 7 (Business Profits) of the OECD Model, under which the exclusive right to tax is allocated to the State of residence unless the services are performed through a permanent establishment that the enterprise maintains in the other State. If this is the case, the latter State may tax the profits attributable to the permanent establishment and the State of residence is obliged to grant relief from double taxation.

107. Article 12 (Royalties) of the OECD Model does not apply to services as it generally deals with payments for the use of, or the righ

State for a period or periods aggregating more than six months within any twelve-month period.

- Secondly, the UN Model currently contains Article 14 dealing with "independent personal services – although its proposed deletion is one subject of this paper. According to this Article, income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character may also be taxed in the other Contracting State if (i) the income is attributable to a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities, or (ii) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, the other Contracting State may tax the income derived from the activities performed therein.

110. The effect of these two rules is basically that profits from services provided in a country over a period of more than 6 months or 183 days can be subjected to source taxation.

B Alternative Provisions in Double Tax Conventions

111. Certain double taxation conventions allow for the taxation of Fees for Technical Services by the State from which payment for the services is made as long as the payment is either made by a resident of that State or borne by a permanent establishment situated therein. This result is typically achieved either by extending the scope of Article 12 (Royalties) (as in many of the treaties of India) or by drafting an article similar to (but additional to)Article 12 to cover fees for technical services (as in many of the treaties of Malaysia). "Standalone" Fees for Technical Services Articles typically limit the source tax that may be levied to a percentage of the fees (e.g. 10/15%) in a way similar to that which is allowed in the case of royalties.

C Policy Considerations

(i) General

112. Policy considerations with respect to the tax treatment of Fees for Technical Services include considerations regarding (a) the source of the income, (b) the mode of taxation, (c) the distinction between technical services and other services, and (d) the applicable thresholds.

(ii) Scos fro11(aAs i)6difficreireaties51nsiervis, bArtmDouble wh 12ties) 8 Ar)T190Tw7(0B-130Alternacalo)5

merely acquired by a resident of a State and that are not produced in that State are not taxable therein and the same principle should arguably apply in the case of services.

115. Clearly, therefore, any attempt by a country to extend its taxing rights to services performed outside that State is likely to be resisted by other countries, which may well consider that the profits from these services should be sourced where they are performed. Whilst the State of residence of the person paying for these services may be relevant for consumption taxation, it seems less acceptable as a nexus for a tax on profits.

(iii) Mode of taxation

116. Another fundamental policy issue relates to the determination of the amount on which tax should be levied. There are several policy reasons why the application of a withholding tax on a payment for services may be considered inappropriate.

117. Expenses incurred to perform a service are recovered through the consideration paid by the client and the application of a withholding tax on a gross basis does not, by definition, take these expenses into account. This will often lead the service provider to "gross-up" the amount charged to the client to include the taxes levied at source by way of withholding tax. The result of such a "gross-up" is that, from an economic point of view, the source State tax is effectively borne by the recipient of the service. As a consequence, a withholding tax levied at source on the gross amount of the payment renders the service more expensive for local enterprises. This greater expense for the consumer will also often result in lower profits in the source State in cases where the expense is allowed as a deduction and a resultant decrease in taxation levied on those profits.

118. In other words, a withholding tax at a fixed rate on payments for services would act as a tariff and would likely be shifted back to the consumer of services in the source State when the contract is signed (both the rate of the tax and the amount of the payment are known at that time). This is more difficult to do with a tax on net profits since the amounts of profit and tax thereon are not known and the consumer is therefore reluctant to agree to bear the cost of that tax. A tax on net profits is in the subcommittee's view less arbitrary and less able to be directly shifted to the consumer than a tax on gross payments. It is, however, more difficult to enforce administratively.

(iv) Distinction between technical services and other services

119. The alternative treaty provisions that allow source taxation of payments for Fees for Technical Services are only applicable to payments for services of a technical, managerial and consultancy nature. This can probably be explained by the fact that such provisions were developed as an extension of the royalty definition. The policy logic seems to have been that since Article 12 allowed source taxation of transfers of technology made through intangible property, a similar rule should apply to transfers of technology made through services (e.g. "show-how" treated as "know-how"). This is evident in the provisions negotiated by India with US and UK, which only apply to payments for services related to the transfer of intangible property. The India-US treaty refers, for example, to "technical or consultancy services (including through the provision of services of technical or other personnel) if such services […] are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or [..] make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design."

120. It is far from clear, however, what is exactly covered by the phrase "services of a technical, managerial and consultancy nature". There has been extensive litigation in India and in other countries on this issue (as well as on the scope of the more limited provision agreed to between India and the US and UK). Cases have also arisen where some countries have tried to stretch the concept of "technical fees" beyond reasonable interpretation, e.g. by trying to include the cost of a building repair as a technical fee.

121. More importantly, it is difficult to find a convincing policy rationale for different treatment of *technical services* as compared to *other services*. Absent good reasons, the non-neutral treatment of one category of services should be avoided. On the assumption that technical services do indeed allow for

D Conclusion on Fees for Technical Services

126. If source taxation of income derived from technical services performed in a State is considered to be appropriate, this should be done through an extension of the permanent establishment concept so as to make the rules of Article 7 applicable rather than through the inclusion in double taxation conventions of a "technical fees" article or the extension of the definition of royalties. In addition, this preferred approach should deal with all service income rather than just technical services. Consistent tax treatment of services would also be a factor and this is one of the aims of tax treaties.

127. This proposed approach would be in line with the above-mentioned policy considerations in that it would (i) only apply to services performed in the source State, (ii) it would do so on a net basis rather than on the basis of the gross payment (iii) it would apply to all services and not only to technical services, and iv) it would not apply to services performed over short periods of time.

IV. Treatment of Services Generally

128. The OECD has recently been considering the effectiveness of the current OECD Model in dealing with the taxation of services, where large scale transactions can occur internationally without a "bricks and mortar" presence. In particular, it has considered whether the current permanent establishment rules represent a suitable allocation of taxing rights as between States.

129. As part of this work, the OECD released for consultation in December 2006 (as noted above[16]) a draft paper on proposed Commentary changes to Article 5. The draft has since been finalized.[17] The OECD have made no changes to the permanent establishment rules but set out in the Commentary an optional provision that States may wish to include as a new paragraph in Article 5 where they wish to tax services performed on their territory based on a time test. The provision is as follows:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

16 At paragraph 114: OECD, "The Tax Treaty Treatment of Services: Proposed Commentary Changes", 8 December 2006.

17 "2008 Update to the OECD Model Tax Convention", 18 July 2008.

Annex 1: Current Relevant Articles of the UN Model[18]

Article 3

1. For the purposes of this Convention, unless the context otherwise requires:

(a) The term "person" includes an individual, a company and any other body of persons;

(b) The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;

(c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(d) The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(e) The term "competent authority" means:

(i) (In State A): .....

(ii) (In State B): .....

(f) The term "national" means:

(i) Any individual possessing the nationality of a Contracting State

(ii) Any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 5

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

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[18] This Annex contains Article 3, 5 and 14, the consideration of which formed the main part of the subcommittee's work. Annex 2 also contains some suggested consequential changes to other provisions.

2. the term “permanent establishment” includes especially:

(a) A place of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term “permanent establishment” also encompasses:

(a) A building site, a construction, assembly or installation project or supervis

(a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 14

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

(a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

(b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that

Annex 2: Relevant Articles of the UN Model – Proposed Amendments

Article 3

1. For the purposes of this Convention, unless the context otherwise requires:

(a) The term "person" includes an individual, a company and any other body of persons;

(b) The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;

(c) The term "enterprise" applies to the carrying on of any business;

(d) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(e) The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(f) The term "competent authority" means:

(i) (In State A): .....

(ii) (In State B): .....

(g) The term "national" means:

(i) Any individual possessing the nationality of a Contracting State

(ii) Any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

(h) The term "business" includes the performance of professional services and of other activities of an independent character.

[(i) The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants.][19]

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19 A proposal has been made for this inclusion – for discussion.

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or

a resident, through a permanent establishment situated therein~~, or performs in that other State independent personal services from a fixed base situated therein~~, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment ~~or fixed base~~. In such case the provisions of article 7 ~~or article 14, as the case may be,~~ shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment ~~or a fixed base~~ situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) The remuneration is not borne by a permanent establishment ~~or a fixed base~~ which the employer has in the other State.

Article 17

1. Notwithstanding the provisions of article~~s 14 and~~ 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of articles 7~~, 14~~ and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

Article 21

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, ~~or performs in that other State independent personal services from a fixed base situated therein,~~ and the right or property in respect of which the income is paid is effectively connected with such permanent establishment ~~or fixed base~~. In such case the provisions of article 7 or ~~article 14, as the case may be,~~ shall apply.

Article 22

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting ~~State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services,~~ may be taxed in that other State.

Annex 3: Proposed Annex for those States Preferring to Retain Article 14[20]

Article 3

1. For the purposes of this Convention, unless the context otherwise requires:

(a) The term “person” includes an individual, a company and any other body of persons;

(b) The term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;

(c) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(d) The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

(b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 10

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11

State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Article 12

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed

Article 15

Title "Dependent Personal Services" retained

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

Article 17

1. Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportspersie r6(Wh4(e(b)T4 1 Tf10.98 0 0 10.98 70.92 489.9203 360 Tc( )T.001 Tw(Article 17)Tj/T21 1 Tf10.02 0 0 10.02 70.92

makes paragraphs 1 and 2 of article 11 inapplicable if the debt claim is effectively connected with the permanent establishment ~~or fixed base~~ or with business activities in the source country of the same or similar kind as those effected through the permanent establishment.

Paragraph 18 of the Commentary on Article 12 should be amended as follows:

This paragraph reproduces with modifications Article 12, paragraph 3, of the OECD Model Convention, which states that paragraph 1 does not apply to royalties beneficially owned by a person having a permanent establishment or permanent base in the source country if the right or property from which the royalties derive

The heading of the Commentary on Article 15 should be changed as follows:

Article 15

~~DEPENDENT PERSONAL SERVICES~~ INCOME FROM EMPLOYMENT[1]

The footnote added should read:

1. Before 20[00], the title of Article 15 referred to 'Dependent Personal Services' by contrast to the title of Article 14, which referred to 'Independent Personal Services'. As a result of the elimination of the latter Article, the title of Article 15 was changed to refer to 'Income from Employment', a term that is more commonly used to describe the activities to which the Article applies. This change was not intended to affect the scope of the Article in any way."

There should be a change to **paragraph 2 of the Commentary on Article 15** (Dependent Personal Services) so that the first sentence reads (deletions and additions highlighted): "Although articles 7~~14~~, 15, 19 and 23 may generally be adequate to prevent double taxation of visiting teachers, some countries may wish to include a visiting teachers article in their treaties."

While the **Commentary on Article 20** includes a discussion on the application of Article 14 to teachers, the discussion is essentially historical. To avoid confusion, the references to Article 14 could be footnoted as follows in paragraph 11 of that Commentary:

During the course of discussions in the Seventh Meeting of the Ad Hoc Group of Experts, several participants argued for the addition to the Model Convention of an article dealing with visiting teachers. Currently, under the Model Convention visiting teachers were subject to article 14[21], if the

The **Commentaries on Articles 17, 20 and 21** should be amended by adding new sentences, probably at the end of paragraph 1 of each Commentary along the following lines: The article was amended to remove references to the "fixed base" concept following the deletion of article 14 from the Model in [20**]."

Annex 5: A Short History of the "Fixed Base" Concept

Historically, the "fixed base" concept goes back to the work of the Organisation for European Economic Cooperation (OEEC – the predecessor to the OECD) in its Reports of 1959. The London (1946) and Mexico (1943) Drafts had used the concept of permanent establishment in the context of independent personal services without reference to a "fixed base".

Article VII(4) of the Mexico Draft read:

> "Income derived by an accountant, an architect, a doctor, an engineer, a lawyer or other person engaged in the practice of a liberal profession shall be taxable only in the contracting State in which the person has a permanent establishment at, or from, which he renders services."

Article VI(4) of the London Draft read:

> "Income derived by an accountant, an architect, an engineer, a lawyer, a physician or other person engaged on his own account in the practice of a profession shall be taxable in the contracting State in which the person has a permanent establishment at, or from, which he renders services."

enterprises the permanent establishment concept was used (Article 5 of the Draft Plurilateral Convention "A" for the Prevention of the Double Taxation of Certain Categories of Income), whereas Article 7 provided:

> "The income of the liberal professions shall be taxable only in the States in which they are regularly exercised."

The 2nd OEEC Report (July 1959) dealt with personal services by including the concept of fixed base (Annex B, Article VI):

> "Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, such part of that income as is attributable to that base may be taxed in that other State."

Paragraph 2 of the Commentary (Annex F) to this Article did not explain the need to make a difference, apart from rather vague 'thoughts':

> "The provisions of Article VI are similar to those customarily adopted for income from industrial or commercial activities. Nevertheless it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities."

The same remark was made in paragraph 3 of the 1963 OECD Commentaries (and paragraph 4 of the 1977 OECD Commentaries). Unfortunately, the paragraph also contemplated that "it has not been thought appropriate to try to define it".

The UN Commentaries cite paragraph 4 of the 1977 OECD Model after noting the relevance of that Commentary. (UN Commentary to Article 14, paragraph 10).

As noted in the body of this paper, Article 14 and the concept of fixed base were deleted from the OECD Model in the year 2000 and consequential amendments made, following a report produced earlier that year[25].

[25] OECD, *Issues Related to Article 14 of the Model Tax Convention*, 2000.